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SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-69146; File No. SR-CBOE-2013-027)

March 15, 2013

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing of a Proposed Rule Change Relating to Trading Ahead of Customer Orders and Best Execution and Interpositioning Requirements

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on March 5, 2013, Chicago Board Options Exchange, Incorporated (the “Exchange” or “CBOE”) filed with the Securities and Exchange Commission (the “Commission”) the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend the Rules of CBOE Stock Exchange, LLC (“CBSX”), CBOE’s stock trading facility, by amending the rule related to trading ahead of customer orders and adopting a rule related to best execution and interpositioning requirements. The text of the proposed rule change is provided below.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

(additions are italicized; deletions are [bracketed])

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## **Chicago Board Options Exchange, Incorporated**

### **Rules**

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## **CBOE Stock Exchange (CBSX) Rules**

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### **Rule 53.2 [Trading Permit Holders Acting As Brokers]Prohibition Against Trading Ahead of Customer Orders**

(a) [While Holding Unexecuted Market Order. No Trading Permit Holder shall on the CBSX System (1) personally buy or initiate the purchase of any security subject to the rules in these Chapters for his own account or for any account in which he or his TPH organization or any member, partner, officer, or employee is directly or indirectly interested, while such Trading Permit Holder personally holds or has knowledge that his TPH organization or any member, partner, officer or employee holds an unexecuted market order to buy such security in the unit of trading for a customer, or (2) personally sell or initiate the sale of any security subject to the rules in these Chapters for any such account, while he personally holds or has knowledge that his TPH organization or any member, partner, officer or employee holds an unexecuted market order to sell such security in the unit of trading for a customer.]Except as provided herein, a Trading Permit Holder that accepts and holds an order in an equity security from its own customer or a customer of another broker-dealer without immediately executing the order is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer

order, unless it immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account.

(b) [While Holding Unexecuted Limit Order. No Trading Permit Holder shall on CBSX (1) personally buy or initiate the purchase of any security subject to the rules in these Chapters for any such account, at or below the price at which he personally holds or has knowledge that his TPH organization or any member, partner, officer or employee holds an unexecuted limited price order to buy such security in the unit of trading for a customer, or (2) personally sell or initiate the sale of any security for any such account at or above the price at which he personally holds or has knowledge that his TPH organization or any member, partner, officer or employee holds an unexecuted limited price order to sell such security in the unit of trading for a customer.]A Trading Permit Holder must have written procedures in place governing the execution and priority of all pending orders that is consistent with the requirements of this Rule and Rule 53.8. A Trading Permit Holder also must ensure that these procedures are consistently applied.

[(c) Special Contract Exemption. The provisions of this Rule shall not apply to any purchase or sale of a security the delivery of which is to be upon a day other than the day of delivery provided in such unexecuted market or limited price order.]

**... Interpretations and Policies:**

**.01 Large Orders and Institutional Account Exceptions.** With respect to orders for customer accounts that meet the definition of an “institutional account” (as defined below) or for orders of 10,000 shares or more (unless such orders are less than \$100,000 in value), a Trading Permit Holder is permitted to trade a security on the same side of the market for its own account at a price that would satisfy such customer order, provided that the Trading Permit Holder has provided clear and comprehensive written disclosure to such customer at account opening and annually thereafter that:

(a) discloses that the Trading Permit Holder may trade proprietarily at prices that would satisfy the customer order, and

(b) provides the customer with a meaningful opportunity to opt in to the Rule 53.2 protections with respect to all or any portion of its order.

If the customer does not opt in to the Rule 53.2 protections with respect to all or any portion of its order, the Trading Permit Holder may reasonably conclude that such customer has consented to the Trading Permit Holder trading a security on the same side of the market for its own account at a price that would satisfy the customer's order.

In lieu of providing written disclosure to customers at account opening and annually thereafter, a Trading Permit Holder may provide clear and comprehensive oral disclosure to and obtain consent from the customer on an order-by-order basis, provided that the Trading Permit Holder documents who provided such consent and such consent evidences the customer's understanding of the terms and conditions of the order.

For purposes of this rule, the term "institutional account" shall mean the account of:

(A) a bank, savings and loan association, insurance company, or registered investment company;

(B) an investment adviser registered either with the Securities and Exchange Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or

(C) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

**.02 No-Knowledge Exception.** With respect to NMS stocks, as defined in Rule 600 of SEC Regulation NMS, if a Trading Permit Holder implements and utilizes an effective system of internal controls, such as appropriate information barriers, that operate to prevent one trading unit from

obtaining knowledge of customer orders held by a separate trading unit, those other trading units trading in a proprietary capacity may continue to trade at prices that would satisfy the customer orders held by the separate trading unit. A Trading Permit Holder that structures its order handling practices in NMS stocks to permit its proprietary and/or market-making desk to trade at prices that would satisfy customer orders held by a separate trading unit must disclose in writing to its customers, at account opening and annually thereafter, a description of the manner in which customer orders are handled by the Trading Permit Holder and the circumstances under which the Trading Permit Holder may trade proprietarily at its proprietary and/or market-making desk at prices that would satisfy the customer order.

If a Trading Permit Holder intends to rely on this exception by implementing information barriers, those information barriers (i) must provide for the organizational separation of a Trading Permit Holder's customer order trading unit and proprietary trading unit; (ii) must ensure that one trading unit does not exert influence over the other trading unit; (iii) must ensure that information relating to each trading unit's stock positions, trading activities, and clearing and margin arrangements is not improperly shared (except with persons in senior management who are involved in exercising general managerial oversight of one or both entities); (iv) must require each trading unit to maintain separate books and records (and separate financial accounting); (v) must require each trading unit to separately meet all required capital requirements; (vi) must ensure the confidentiality of the trading unit's book as provided by Exchange rules; and (vii) must ensure that any other material, non-public information (e.g. information related to any business transactions between the trading unit and an issuer or any research reports or recommendations issued by the trading unit) is not made improperly available to the other trading unit in any manner that would allow that trading unit to

take undue advantage of that information while trading on CBSX. A Trading Permit Holder must submit the proposed information barriers in writing to the Exchange upon request.

**.03 ISO Exception.** A Trading Permit Holder shall be exempt from the obligation to execute a customer order in a manner consistent with this Rule with regard to trading for its own account that is the result of an intermarket sweep order routed in compliance with Rule 600(b)(30)(ii) of SEC Regulation NMS (“ISO”) where the customer order is received after the Trading Permit Holder routed the ISO. Where a Trading Permit Holder routes an ISO to facilitate a customer order and that customer has consented to not receiving the better prices obtained by the ISO, the Trading Permit Holder also shall be exempt with respect to any trading for its own account that is the result of the ISO with respect to the consenting customer’s order.

**.04 Odd Lot and Bona Fide Error Transaction Exceptions.** The obligations under this Rule shall not apply to a Trading Permit Holder’s proprietary trade that is (1) to offset a customer order that is in an amount less than a normal unit of trading; or (2) to correct a bona fide error. Trading Permit Holders are required to demonstrate and document the basis upon which a transaction meets the bona fide error exception.

**.05 Minimum Price Improvement Standards.** The minimum amount of price improvement necessary for a Trading Permit Holder to execute an order on a proprietary basis when holding an unexecuted limit order in that same security, and not be required to execute the held limit order is as follows:

(a) For customer limit orders priced greater than or equal to \$1.00, the minimum amount of price improvement required is \$0.01;

(b) For customer limit orders priced greater than or equal to \$0.01 and less than \$1.00, the minimum amount of price improvement required is the lesser of \$0.01 or one-half (1/2) of the current inside spread;

(c) For customer limit orders priced less than \$0.01 but greater than or equal to \$0.001, the minimum amount of price improvement required is the lesser of \$0.001 or one-half (1/2) of the current inside spread;

(d) For customer limit orders priced less than \$0.001 but greater than or equal to \$0.0001, the minimum amount of price improvement required is the lesser of \$0.0001 or one-half (1/2) of the current inside spread;

(e) For customer limit orders priced less than \$0.0001 but greater than or equal to \$0.00001, the minimum amount of price improvement required is the lesser of \$0.00001 or one-half (1/2) of the current inside spread;

(f) For customer limit orders priced less than \$0.00001, the minimum amount of price improvement required is the lesser of \$0.000001 or one-half (1/2) of the current inside spread; and

(g) For customer limit orders priced outside the best inside market, the minimum amount of price improvement required must either meet the requirements set forth above or the Trading Permit Holder must trade at a price at or inside the best inside market for the security.

In addition, if the minimum price improvement standards above would trigger the protection of a pending customer limit order, any better-priced customer limit order(s) must also be protected under this Rule, even if those better-priced limit orders would not be directly triggered under the minimum price improvement standards above.

**.06 Order Handling Procedures.** A Trading Permit Holder must make every effort to execute a marketable customer order that it receives fully and promptly. A Trading Permit Holder that is

holding a customer order that is marketable and has not been immediately executed must make every effort to cross such order with any other order received by the Trading Permit Holder on the other side of the market up to the size of such order at a price that is no less than the best bid and no greater than the best offer at the time that the subsequent order is received by the Trading Permit Holder and that is consistent with the terms of the orders. In the event that a Trading Permit Holder is holding multiple orders on both sides of the market that have not been executed, the Trading Permit Holder must make every effort to cross or otherwise execute such orders in a manner that is reasonable and consistent with the objectives of this Rule and with the terms of the orders. A Trading Permit Holder can satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price.

**.07 Trading Outside Normal Market Hours.** Trading Permit Holder s generally may limit the life of a customer order to the period of normal market hours of 8:30 a.m. to 3:00 p.m. Central Time. However, if the customer and Trading Permit Holder agree to the processing of the customer’s order outside normal market hours, the protections of this Rule shall apply to that customer’s order(s) at all times the customer order is executable by the Trading Permit Holder.

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**Rule 53.8. Best Execution and Interpositioning[Reserved]**

[Reserved](a)(1) In any transaction for or with a customer or a customer of another broker-dealer, a Trading Permit Holder and persons associated with a Trading Permit Holder shall use reasonable diligence to ascertain the best market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that will be considered in determining whether a Trading Permit Holder or person associated with a Trading Permit Holder has used “reasonable diligence” are:



(A) the character of the market for the security (e.g., price, volatility, relative liquidity, and pressure on available communications);

(B) the size and type of transaction;

(C) the number of markets checked;

(D) accessibility of the quotation; and

(E) the terms and conditions of the order which result in the transaction, as communicated to the Trading Permit Holder and persons associated with the Trading Permit Holder.

(2) In any transaction for or with a customer or a customer of another broker-dealer, no Trading Permit Holder or person associated with a Trading Permit Holder shall interject a third party between the Trading Permit Holder or the person associated with a Trading Permit Holder and the best market for the subject security in a manner inconsistent with paragraph (a)(1) of this Rule.

(b) When a Trading Permit Holder cannot execute directly with a market but must employ a broker's broker or some other means in order to ensure an execution advantageous to the customer, the burden of showing the acceptable circumstances for doing so is on the Trading Permit Holder.

(c) Failure to maintain or adequately staff a department assigned to execute customers' orders cannot be considered justification for executing away from the best available market; nor can channeling orders through a third party as described above as reciprocation for service or business operate to relieve a Trading Permit Holder of its obligations under this Rule.

(d) A Trading Permit Holder through which an order is channeled and that knowingly is a party to an arrangement whereby the initiating Trading Permit Holder has not fulfilled its obligations under this Rule will also be deemed to have violated this Rule.

(e) The obligations described in paragraphs (a) through (d) above exist not only when the Trading Permit Holder acts as agent for the account of its customer but also when transactions are executed as principal.

**... Interpretations and Policies:**

**.01 Execution of Marketable Customer Orders.** A Trading Permit Holder must make every effort to execute a marketable customer order that it receives fully and promptly.

**.02 Definition of “Market.”** For the purposes of Rule 53.8 and the accompanying Interpretations and Policies, the term “market” or “markets” is to be construed broadly, and it encompasses a variety of different venues, including, but not limited to, market centers that are trading a particular security. This expansive interpretation is meant to both inform broker-dealers as to the breadth of the scope of venues that must be considered in the furtherance of their best execution obligations and to promote fair competition among broker-dealers, exchange markets, and markets other than exchange markets, as well as any other venue that may emerge, by not mandating that certain trading venues have less relevance than others in the course of determining a firm’s best execution obligations.

**.03 Best Execution and Executing Brokers.** A Trading Permit Holder’s duty to provide best execution in any transaction “for or with a customer of another broker-dealer” does not apply in instances when another broker-dealer is simply executing a customer order against the Trading Permit Holder’s quote. The duty to provide best execution to customer orders received from other broker-dealers arises only when an order is routed from the broker-dealer to the Trading Permit Holder for the purpose of order handling and execution. This clarification is intended to draw a distinction between those situations in which the Trading Permit Holder is acting solely as the buyer or seller in connection with orders presented by a broker-dealer against the Trading Permit Holder’s

quote, as opposed to those circumstances in which the Trading Permit Holder is accepting order flow from another broker-dealer for the purpose of facilitating the handling and execution of such orders.

**.04 Use of a Broker's Broker.** Paragraph (b) of Rule 53.8 provides that when a Trading Permit Holder cannot execute directly with a market but must employ a broker's broker or some other means in order to ensure an execution advantageous to the customer, the burden of showing the acceptable circumstances for doing so is on the Trading Permit Holder. Examples of acceptable circumstances are where a customer's order is "crossed" with another firm that has a corresponding order on the other side, or where the identity of the firm, if known, would likely cause undue price movements adversely affecting the cost or proceeds to the customer.

**.05 Orders Involving Securities with Limited Quotations or Pricing Information.** Although the best execution requirements in Rule 53.8 apply to orders in all securities, markets for securities differ dramatically. One of the areas in which a Trading Permit Holder must be especially diligent in ensuring that it has met its best execution obligations is with respect to customer orders involving securities for which there is limited pricing information or quotations available. Each Trading Permit Holder must have written policies and procedures in place that address how the Trading Permit Holder will determine the best inter-dealer market for such a security in the absence of pricing information or multiple quotations and must document its compliance with those policies and procedures. For example, a Trading Permit Holder should analyze pricing information based on other data, such as previous trades in the security, to determine whether the resultant price to the customer is as favorable as possible under prevailing market conditions. In these instances, a Trading Permit Holder should generally seek out other sources of pricing information or potential

liquidity, which may include obtaining quotations from other sources (e.g., other firms that the Trading Permit Holder previously has traded with in the security).

**.06 Customer Instructions Regarding Order Handling.** If a Trading Permit Holder receives an unsolicited instruction from a customer to route that customer's order to a particular market for execution, the Trading Permit Holder is not required to make a best execution determination beyond the customer's specific instruction. Trading Permit Holders are, however, still required to process that customer's order promptly and in accordance with the terms of the order. Where a customer has directed that an order be routed to another specific broker-dealer that is also a Trading Permit Holder, the receiving Trading Permit Holder to which the order was directed would be required to meet the requirements of Rule 53.8 with respect to its handling of the order.

**.07 Regular and Rigorous Review of Execution Quality.**

(a) No Trading Permit Holder can transfer to another person its obligation to provide best execution to its customers' orders. A Trading Permit Holder that routes customer orders to other broker-dealers for execution on an automated, non-discretionary basis, as well as a Trading Permit Holder that internalizes customer order flow, must have procedures in place to ensure the Trading Permit Holder periodically conducts regular and rigorous reviews of the quality of the executions of its customers' orders if it does not conduct an order-by-order review. The review must be conducted on a security-by-security, type-of-order basis (e.g., limit order, market order, and market on open order). At a minimum, a Trading Permit Holder must conduct such reviews on a quarterly basis; however, Trading Permit Holders should consider, based on the firm's business, whether more frequent reviews are needed.

(b) In conducting its regular and rigorous review, a Trading Permit Holder must determine whether any material differences in execution quality exist among the markets trading the security and, if so,

modify the Trading Permit Holder's routing arrangements or justify why it is not modifying its routing arrangements. To assure that order flow is directed to markets providing the most beneficial terms for their customers' orders, the Trading Permit Holder must compare, among other things, the quality of the executions the Trading Permit Holder is obtaining via current order routing and execution arrangements (including the internalization of order flow) to the quality of the executions that the Trading Permit Holder could obtain from competing markets. In reviewing and comparing the execution quality of its current order routing and execution arrangements to the execution quality of other markets, a Trading Permit Holder should consider the following factors:

(1) price improvement opportunities (i.e., the difference between the execution price and the best quotes prevailing at the time the order is received by the market);

(2) differences in price disimprovement (i.e., situations in which a customer receives a worse price at execution than the best quotes prevailing at the time the order is received by the market);

(3) the likelihood of execution of limit orders;

(4) the speed of execution;

(5) the size of execution;

(6) transaction costs;

(7) customer needs and expectations; and

(8) the existence of internalization or payment for order flow arrangements.

(c) A Trading Permit Holder that routes its order flow to another Trading Permit Holder that has agreed to handle that order flow as agent for the customer (e.g., a clearing firm or other executing broker-dealer) can rely on that Trading Permit Holder's regular and rigorous review as long as the statistical results and rationale of the review are fully disclosed to the Trading Permit Holder and the

Trading Permit Holder periodically reviews how the review is conducted, as well as the results of the review.

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The text of the proposed rule change is also available on the Exchange's website (<http://www.cboe.com/AboutCBOE/CBOELegalRegulatoryHome.aspx>), at the Exchange's Office of the Secretary, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to amend Rule 53.2 of the CBSX Rules, which governs the treatment of customer orders and prohibits a CBSX Trading Permit Holder from proprietarily trading ahead of a customer order, and to adopt Rule 53.8 in the CBSX Rules to govern Trading Permit Holders' best execution and interpositioning requirements. This proposed rule change is consistent with Financial Industry Regulatory Authority ("FINRA") Rules 5320 (Prohibition Against Trading Ahead of Customer Orders)<sup>3</sup> and 5310 (Best Execution and Interpositioning),<sup>4</sup>

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<sup>3</sup> See Securities Exchange Act Release No. 63895 (February 11, 2011), 76 FR 9386 (February 17, 2011) (SR-FINRA-2009-090) (order approving FINRA Rule 5320, "Prohibition Against Trading Ahead of Customer Orders"). Other exchanges have adopted substantially similar rules prohibiting trading ahead of customer orders. See,

respectively, in the Consolidated FINRA Rulebook. The purpose of these rules is to enhance customer order protection and help customers receive efficient executions of their transactions at the best market prices.

#### Rule 53.2 – Prohibition Against Trading Ahead of Customer Orders

Currently, Rule 53.2 prohibits a Trading Permit Holder on the CBSX System<sup>5</sup> from trading for its own account any security subject to the CBSX Rules while the Trading Permit Holder personally holds or has knowledge that his Trading Permit Holder organization (or any member, partner, officer or employee) holds an unexecuted market order to buy or sell that security in the unit of trading for a customer.<sup>6</sup> Rule 53.2 also prohibits a Trading Permit Holder on the CBSX System from trading for its own account any security subject to the CBSX Rules at

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e.g., Securities Exchange Act Release No. 64418 (May 6, 2011), 76 FR 27735 (May 12, 2011) (SR-CHX-2011-008) (notice of filing and immediate effectiveness of proposed rule change of Chicago Stock Exchange, Inc. to adopt customer order protection language consistent with FINRA Rule 5320); Securities Exchange Act Release No. 65165 (August 18, 2011), 76 FR 53009 (August 24, 2011) (SR-NYSEAmex-2011-059) (notice of filing and immediate effectiveness of proposed rule change of NYSE Amex LLC (now known as NYSE MKT LLC) to adopt customer order protection language substantially the same as FINRA Rule 5320); and Securities Exchange Act Release No. 65166 (August 18, 2011), 76 FR 53012 (August 24, 2011) (SR-NYSEArca-2011-057) (notice of filing and immediate effectiveness of proposed rule change of NYSE Arca, Inc. to adopt customer order protection language substantially the same as FINRA Rule 5320).

<sup>4</sup> See Securities Exchange Act Release No. 65895 (December 5, 2011), 76 FR 77042 (December 9, 2011) (SR-FINRA-2011-052) (order approving FINRA Rule 5310, “Best Execution and Interpositioning”). Other exchanges have similar best execution and interpositioning rules. See, e.g., NASDAQ Stock Market LLC Rule 2320 (Best Execution and Interpositioning) and IM-2320; and NASDAQ OMX PHLX LLC Rule 764 (Best Execution and Interpositioning).

<sup>5</sup> The “CBSX System” means the electronic system that performs the functions set out in the CBSX Rules, including controlling, monitoring, and recording trading by Trading Permit Holders through CBSX Workstations and trading between Trading Permit Holders. See Rule 50.1.

<sup>6</sup> Rule 53.2 currently also provides a special contract exemption, stating that the provisions of the Rule do not apply to any purchase or sale of a security the delivery of which is to be upon a day other than the day of delivery provided in the unexecuted market or limit order.

a price that is equal to or better [sic] the price at which the Trading Permit Holder personally holds or has knowledge that his Trading Permit Holder organization (or any member, partner, officer or employee) holds an unexecuted limit order to buy or sell that security in the unit of trading for a customer.

The proposed rule change replaces in its entirety the text of Rule 53.2 and adds a number of exceptions. Proposed Rule 53.2 includes customer order protection language similar to the current Rule that states if a Trading Permit Holder holds an order in an equity security from its own customer or a customer of another broker-dealer, the Trading Permit Holder is prohibited from trading that security on the same side of the market for its own account at a price that would satisfy the customer order. The proposed rule change adds that this prohibition does not apply if a Trading Permit Holder, who has traded proprietarily ahead of a customer order, immediately thereafter executes the customer order up to the size and at the same or better price at which it traded for its own account. In other words, in the event that a Trading Permit Holder trades ahead of an unexecuted customer order at a price that is equal to or better than the unexecuted customer order on the CBSX System, the Trading Permit Holder is required to execute the customer order at the price received by the Trading Permit Holder or better; otherwise the Trading Permit Holder will be in violation of improperly trading ahead of the customer order.<sup>7</sup> The proposed rule change also establishes the minimum amount of price improvement necessary for a Trading Permit Holder to execute an order on a proprietary basis when holding an unexecuted limit order.<sup>8</sup>

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<sup>7</sup> For example, if a Trading Permit Holder buys 100 shares of a security at \$10 per share while holding customer limit orders in the same security to buy at \$10 per share equaling, in aggregate, 1000 shares, the Trading Permit Holder is required to fill 100 shares of the customer limit orders at \$10 per share or better.

<sup>8</sup> See proposed Rule 53.2, Interpretation and Policy .05. For example, for customer limit orders priced greater than or equal to \$1.00, the minimum amount of price improvement required is \$0.01.



The Exchange also proposes to establish that a Trading Permit Holder must have written procedures in place governing the execution and priority of all pending orders that is consistent with proposed Rule 53.2 and the best execution requirements of proposed Rule 53.8 and ensure that these procedures are consistently applied.

In furtherance of ensuring customer order protection on CBSX, the proposed rule change clarifies Trading Permit Holder obligations in handling marketable customer orders. In meeting these obligations, a Trading Permit Holder must make every effort to execute a marketable customer order that it receives fully and promptly. A Trading Permit Holder that is holding a customer order that is marketable and has not been immediately executed must make every effort to cross the order with any other order received by the Trading Permit Holder on the other side of the market up to the size of such order at a price that is no less than the best bid and no greater than the best offer at the time that the subsequent order is received by the Trading Permit Holder and that is consistent with the terms of the orders. In the event that a Trading Permit Holder is holding multiple orders on both sides of the market that have not been executed, the Trading Permit Holder must make every effort to cross or otherwise execute these orders in a manner that is reasonable and consistent with the objects of the proposed rule change and with the terms of the orders. A Trading Permit Holder can satisfy the crossing requirement by contemporaneously buying from the seller and selling to the buyer at the same price.<sup>9</sup>

#### Large Orders and Institutional Accounts Exception<sup>10</sup>

The most notable proposed exception to the prohibition on trading ahead of customer orders permits Trading Permit Holders to negotiate terms and conditions on the acceptance of certain large-sized orders (orders of 10,000 shares or more and greater than or equal to \$100,000

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<sup>9</sup> See proposed Rule 53.2, Interpretation and Policy .06.

<sup>10</sup> See proposed Rule 53.2, Interpretation and Policy .01.

in value) or orders from institutional accounts.<sup>11</sup> These terms and conditions would permit Trading Permit Holders to continue to trade along side or ahead of these customer orders if the customer agrees.

Specifically, under the proposed rule, a Trading Permit Holder would be permitted to trade a security on the same side of the market for its own account at a price that would satisfy a customer order provided that the Trading Permit Holder provides clear and comprehensive written disclosure to each customer at account opening and annually thereafter that: (1) discloses that the Trading Permit Holder may trade proprietarily at prices that would satisfy the customer order, and (b) provides the customer with a meaningful opportunity to opt in to the Rule 53.2 protections with respect to all or any portion of its order(s).

If a customer does not opt in to the Rule 53.2 protections with respect to all or any portion of its order(s), the Trading Permit Holder may reasonably conclude that the customer has consented to the Trading Permit Holder trading a security on the same side of the market for its own account at a price that would satisfy the customer's order.<sup>12</sup>

In lieu of providing written disclosure to customers at account opening and annually thereafter, the proposed rule would permit Trading Permit Holders to provide clear and comprehensive oral disclosure to, and obtain consent from, a customer on an order-by-order

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<sup>11</sup> Proposed Rule 53.2, Interpretation and Policy .01 defines "institutional account" as an account of: (a) a bank, savings and loan association, insurance company, or registered investment company; (b) an investment adviser registered either with the Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or (c) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

<sup>12</sup> As is always the case, customers retain the right to withdraw consent at any time. Therefore, a Trading Permit Holder's reasonable conclusion that a customer has consented to the Trading Permit Holder trading along with the customer's order is subject to further instruction and modification from the customer.

basis, provided that the Trading Permit Holder documents who provided that consent and that the consent evidences the customer's understanding of the terms and conditions of the order. In addition, where a customer has opted in to the Rule 53.2 protections, a Trading Permit Holder may still obtain consent on an order-by-order basis to trade ahead of or along with an order from that customer, provided that the Trading Permit Holder documents who provided the consent and that the consent evidences the customer's understanding of the terms and conditions of the order.<sup>13</sup>

#### No-Knowledge Exception<sup>14</sup>

The Exchange also proposes to add a “no-knowledge” exception to CBSX’s customer order protection rule. This proposed exception would allow a proprietary trading unit of a Trading Permit Holder organization to continue trading in a proprietary capacity and at prices that would satisfy customer orders that were being held by another, separate trading unit at the Trading Permit Holder organization. The “no-knowledge” exception would be applicable with respect to NMS stocks, as defined in Rule 600 of SEC Regulation NMS. In order to avail itself of the “no-knowledge” exception, a Trading Permit Holder organization must first implement and utilize an effective system of internal controls (such as appropriate information barriers) that operate to prevent the proprietary trading unit from obtaining knowledge of the customer orders

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<sup>13</sup> While a Trading Permit Holder organization relying on this or any exception must be able to proffer evidence of its eligibility for and compliance with the exception, the Exchange believes that when obtaining consent on an order-by-order basis, Trading Permit Holders must, at a minimum, document not only the terms and conditions of the order (e.g., the relative price and size of the allocated order/percentage split with the customer), but also the identity of the person at the customer who approved the trade-along request. For example, the identity of the person must be noted in a manner that will enable subsequent contact with that person if a question as to the consent arises (i.e., first names only, initials, and nicknames will not suffice). A “trade along” request would be when a Trading Permit Holder asks to trade for his/her proprietary account while simultaneously holding and working a customer order in that same stock.

<sup>14</sup> See proposed Rule 53.2, Interpretation and Policy .02.

that are held at a separate trading unit. For example, a CBSX Broker<sup>15</sup> that conducts both a proprietary and agency brokerage business and has implemented and utilized an effective system of internal controls, the “walled off” proprietary desk(s) of the CBSX Broker would be permitted to trade at prices that would satisfy the customer orders held by the agency brokerage desk without any requirement that these proprietary executions trigger an obligation to fill pending customer orders at the same price. The “no-knowledge” exception would also apply to a Trading Permit Holder organization’s market-making unit.

A Trading Permit Holder organization that structures its order handling practices in NMS stocks to permit its proprietary and/or market-making desk to trade at prices that would satisfy customer orders held as a separate trading unit must disclose in writing to its customers, at account opening and annually thereafter, a description of the manner in which customer orders are handled by the Trading Permit Holder and the circumstances under which the Trading Permit Holder may trade proprietarily at its market-making desk at prices that would satisfy the customer order. This proposed disclosure may be combined with the disclosure and negative consent statement permitted in connection with the proposed large order and institutional account exceptions.

If a Trading Permit Holder intends to rely on the no-knowledge exception by implementing information barriers, those information barriers must (1) provide for the organizational separation of a Trading Permit Holder’s trading unit that holds customer orders and a proprietary trading unit; (2) ensure that one trading unit does not exert influence over the other trading unit; (3) ensure that information relating to each trading unit’s stock positions, trading activities, and clearing and margin arrangements is not improperly shared (except with persons in senior management who are

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<sup>15</sup> A “CBSX Broker” is a Trading Permit Holder who enters orders as an agent. See Rule 50.3(5).

involved in exercising general managerial oversight of one or both entities); (4) require each trading unit to maintain separate books and records (and separate financial accounting); (5) require each trading unit to separately meet all required capital requirements; (6) ensure the confidentiality of each trading unit's book as provided by Exchange rules; and (7) ensure that any other material, non-public information (e.g. information related to any business transactions between a trading unit and an issuer or any research reports or recommendations issued by the trading unit) is not made improperly available to the other trading unit in any manner that would allow that trading unit to take undue advantage of that information while trading on CBSX. A Trading Permit Holder must submit the proposed information barriers in writing to the Exchange upon request.

Similar to FINRA Rule 5320, the proposed rule change requires Trading Permit Holders that intend to rely on the no-knowledge exception by implementing information barriers to have "appropriate" information barriers. The Exchange believes that including these specific information barrier requirements will clarify for Trading Permit Holders what types of information barriers would be deemed appropriate information barriers and thus better allow Trading Permit Holders to rely on this exception. The Exchange notes that its surveillance procedures will continue to include a review of all orders for compliance with the prohibition on trading ahead of customer orders, and part of that will review [sic] include review of Trading Permit Holders' information barriers to determine whether they are sufficient for the Trading Permit Holders to avail themselves of the no-knowledge exception for each applicable order. These requirements regarding information barriers are substantially similar to those set forth in CBOE Rule 54.8, which includes special provisions for trading commodity-based trust shares on CBSX, except that the proposed rule change provides that information barriers must be submitted upon request while CBOE Rule 54.8 provides that information barriers must be

submitted and approved in advance. The Exchange believes it is appropriate and efficient to request from a Trading Permit Holder its information barriers as part of its surveillance procedures with respect to the customer order protection rule.

#### ISO Exception<sup>16</sup>

The proposed rule change also clarifies that a Trading Permit Holder will be exempt from the obligation to execute a customer order in a manner consistent with CBSX's customer order protection rule with regard to trading for its own account that is the result of an intermarket sweep order routed in compliance with Rule 600(b)(30)(ii) of SEC Regulation NMS ("ISO") where the customer order is received after the Trading Permit Holder routed the ISO. Where a Trading Permit Holder routes an ISO to facilitate a customer order and that customer has consented to not receiving the better prices obtained by the ISO, the Trading Permit Holder also will be exempt with respect to any trading for its own account that is the result of the ISO with respect to the consenting customer's order.

#### Odd Lot and Bona Fide Error Transaction Exception<sup>17</sup>

The Exchange also proposes applying an exception for a firm's proprietary trade that (1) offsets a customer odd lot order (i.e., an order less than one round lot, which is typically 100 shares); or (2) corrects a bona fide error. With respect to bona fide errors, Trading Permit Holder would be required to demonstrate and document the basis upon which a transaction meets the bona fide error exception. For purposes of this proposed Rule, the definition of a "bona fide error" is as defined in SEC Regulation NMS's exemption for error correction transactions.<sup>18</sup>

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<sup>16</sup> See proposed Rule 53.2, Interpretation and Policy .03.

<sup>17</sup> See proposed Rule 53.2, Interpretation and Policy .04.

<sup>18</sup> See Securities Exchange Act Release No. 55884 (June 8, 2007), 72 FR 32926 (June 14, 2007) (Order Exempting Certain Error Correction Transactions from Rule 611 of Regulation NMS under the Securities Exchange Act of 1934).

### Trading Outside Normal Market Hours<sup>19</sup>

This proposed rule change also expands CBSX's customer order protection requirements to apply at all times that a customer order is executable by the Trading Permit Holder, even outside the period of normal market hours. Thus, customers would have the benefit of the customer order protection rules at all times where such order is executable by the Trading Permit Holder, subject to any applicable exceptions. This exception will apply to those Trading Permit Holders that accept customer orders after normal market hours.

### Rule 53.8 – Best Execution and Interpositioning

The Exchange proposes to adopt a new rule to govern Trading Permit Holders' best execution and interpositioning requirements. Proposed Rule 53.8(a)(1) requires a Trading Permit Holder or person associated with a Trading Permit Holder, in any transaction for or with a customer or a customer of another broker-dealer, to use "reasonable diligence" to ascertain the best market for a security and to buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. The rule identifies five factors that are among those to be considered in determining whether the Trading Permit Holder or person associated with a Trading Permit Holder has used reasonable diligence:

- (1)the character of the market for the security;
- (2)the size and type of transaction;
- (3)the number of markets checked;
- (4)the accessibility of the quotation; and
- (5)the terms and conditions of the order as communicated to the Trading Permit Holder or person associated with the Trading Permit Holder.

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<sup>19</sup> See proposed Rule 53.2, Interpretation and Policy .07.

Proposed Rule 53.8(a)(2) relates to interpositioning and prohibits a Trading Permit Holder or person associated with a Trading Permit Holder, in any transaction for or with a customer or a customer of another broker-dealer, from interjecting a third party between the Trading Permit Holder or person associated with a Trading Permit Holder and the best market for the subject security in a manner inconsistent with the best execution requirements in subparagraph (a)(1) of proposed Rule 53.8.

Proposed Rule 53.8 also includes provisions related to the use of a broker's broker, the staffing of order rooms, and the application of the best execution requirements to other parties. Proposed paragraph (b) provides that when a Trading Permit Holder cannot execute directly with a market but must employ a broker's broker or some other means in order to ensure an execution advantageous to the customer, the burden of showing the acceptable circumstances for doing so is on the Trading Permit Holder. Proposed paragraph (c) provides that failure to maintain or adequately staff a department assigned to execute customers' orders cannot be considered justification for executing away from the best available market; nor can channeling orders through a third party as reciprocation for service or business operate to relieve a Trading Permit Holder of its obligations under proposed Rule 53.8. Proposed paragraph (d) provides that a Trading Permit Holder through which an order is channeled and that knowingly is a party to an arrangement whereby the initiating Trading Permit Holder has not fulfilled its obligations under Rule 53.8 will also be deemed to have violated Rule 53.8. Proposed paragraph (e) provides that the obligations in paragraphs (a) through (d) apply when the Trading Permit Holder acts as agent for the account of its customer as well as when transactions are executed as principal.

Proposed Rule 53.8 includes several Interpretations and Policies to provide additional guidance and clarity regarding Trading Permit Holders' obligations with respect to the best



execution and interpositioning requirements. Proposed Interpretation and Policy .01 reinforces a Trading Permit Holder's duty to make every effort to execute a marketable customer order that it receives fully and promptly. Proposed Interpretation and Policy .02 defines the term "market" for the purposes of proposed Rule 53.8.<sup>20</sup>

Proposed Interpretation and Policy .03 addresses broker-dealers that are executing a customer's order against the Trading Permit Holder's quote. It provides that a Trading Permit Holder's duty to provide best execution in any transaction "for or with a customer of another broker-dealer" does not apply in instances when another broker-dealer is simply executing a customer order against the Trading Permit Holder's quote. The duty to provide best execution to customer orders received from other broker-dealers arises only when an order is routed from the broker-dealer to the Trading Permit Holder for the purpose of order handling and execution. This clarification is intended to draw a distinction between those situations in which the Trading Permit Holder is acting solely as the buyer or seller in connection with orders presented by a broker-dealer against the Trading Permit Holder's quote, as opposed to those circumstances in which the Trading Permit Holder is accepting order flow from another broker-dealer for the purpose of facilitating the handling and execution of such orders.

Proposed Interpretation and Policy .04 provides that when a Trading Permit Holder cannot execute directly with a market but must employ a broker's broker or some other means in

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<sup>20</sup> For purposes of proposed Rule 53.8 and the accompanying Interpretations and Policies, the term "market" or "markets" is to be construed broadly, and it encompasses a variety of different venues, including, but not limited to, market centers that are trading a particular security. This expansive interpretation is meant to both inform broker-dealers as to the breadth of the scope of venues that must be considered in the furtherance of their best execution obligations and to promote fair competition among broker-dealers, exchange markets, and markets other than exchange markets, as well as any other venue that may emerge, by not mandating that certain trading venues have less relevance than others in the course of determining a firm's best execution obligations.

order to ensure an execution advantageous to the customer, the burden of showing the acceptable circumstances for doing so is on the Trading Permit Holder. Examples of acceptable circumstances are where a customer's order is crossed with another firm that has a corresponding order on the other side, or where the identity of the firm, if known, would likely cause undue price movements adversely affecting the cost or proceeds to the customer.

Proposed Interpretation and Policy .05 addresses the fact that markets for securities differ dramatically and provides additional guidance regarding a Trading Permit Holder's best execution obligations when handling an order involving any security for which there is limited pricing information or other quotations available. The Interpretation and Policy emphasizes that Trading Permit Holders must be especially diligent with respect to best execution obligations where there is limited quotation or other pricing information available regarding the security that is the subject of the order and requires Trading Permit Holders to have written policies and procedures in place to address the steps the Trading Permit Holder will take to determine the best interdealer market for such a security in the absence of multiple quotations or pricing information and to document how they have complied with those policies and procedures. The Interpretation and Policy specifically notes that, when handling orders for these securities, Trading Permit Holders should generally seek out other sources of pricing information or potential liquidity, which may include obtaining quotations from other sources (e.g., other firms that the Trading Permit Holder previously has traded with in the security). For example, in many instances, particularly in the context of equity securities with limited quotation information available, contacting other broker-dealers may be necessary to comply with a Trading Permit Holder's best execution obligations.

When placing an order with a Trading Permit Holder, customers may specifically instruct the Trading Permit Holder to route the order to a particular market for execution.<sup>21</sup> Proposed Interpretation and Policy .06 addresses situations where the customer has, on an unsolicited basis, specifically instructed the Trading Permit Holder to route that customer's order to a particular market for execution.<sup>22</sup> Under those circumstances, the Trading Permit Holder would not be required to make a best execution determination beyond that specific instruction; however, the Interpretation and Policy mandates that Trading Permit Holders process that customer's order promptly and in accordance with the terms of the order. The Interpretation and Policy also makes clear that where a customer has directed the Trading Permit Holder to route an order to another specific broker-dealer that is also a Trading Permit Holder, the exception would not apply to the receiving Trading Permit Holder to which the order was directed.<sup>23</sup>

Proposed Interpretation and Policy .07 codifies a Trading Permit Holder's obligation when it undertakes a regular and rigorous review of execution quality likely to be obtained from different market centers. These longstanding obligations are set forth and explained in various SEC releases and NASD Notices to Members.<sup>24</sup>

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<sup>21</sup> When the order is for an NMS security, these orders are often referred to as "directed orders." See 17 CFR 242.600(b)(19). Of note, directed orders are excluded from the order routing statistics required to be produced under Rule 606 of SEC Regulation NMS. See 17 CFR 242.606.

<sup>22</sup> The Interpretation and Policy also clarifies that a Trading Permit Holder's best execution obligations extend to all customer orders and is intended to avoid the potential misimpression that the paragraph limits the scope of the rule's requirements.

<sup>23</sup> For example, if a customer of Trading Permit Holder Firm A directs Trading Permit Holder Firm A to route an order to Trading Permit Holder Firm B, Trading Permit Holder Firm B would continue to have best execution obligations to that customer order received from Trading Permit Holder Firm A.

<sup>24</sup> See, e.g., Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996); and NASD Notice to Members 01-22 (April 2001).

## 2. Statutory Basis

The Exchange believes the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to the Exchange and, in particular, the requirements of Section 6(b) of the Act.<sup>25</sup> Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)<sup>26</sup> requirements that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitation transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Additionally, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)<sup>27</sup> requirement that the rules of an exchange not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

In particular, the Exchange believes that amending CBSX's customer order protection rule and adopting a best execution and interpositioning rule will promote just and equitable principles of trade and protect investors and the public interest by bringing CBSX's Rules more in line with industry standards, most notably FINRA Rules 5320 and 5310, respectively. Additionally, the requirement to have certain information barriers in place to take advantage of the no-knowledge exception to the prohibition on trading ahead of customer orders is substantially similar to the information barrier requirement set forth in CBOE Rule 54.8 regarding trading commodity-based trust shares on CBSX. The Exchange believes it will be

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<sup>25</sup> 15 U.S.C. 78f(b).

<sup>26</sup> 15 U.S.C. 78f(b)(5).

<sup>27</sup> Id.

efficient to review the information barriers upon request in connection with its overall surveillances procedures related to the customer order protection rule.

The Exchange believes this consistency among Rules of different self-regulatory organizations will in turn reduce the complexity of customer order protection for those firms subject to the rules of multiple trading venues. It will also contribute to investor protection by defining important parameters by which Trading Permit Holders must abide when trading proprietarily and when handling customer orders. In addition, the Exchange believes harmonizing customer order protection, best execution and interpositioning rules across self-regulatory organizations will foster cooperation and contribute to perfecting the mechanism of a free and open market and national market system. The Exchange also believes that including these rules in CBSX's rules will reinforce the importance of these requirements and ensure that Trading Permit Holders are aware of these requirements. The Interpretations and Policies for each Rule will provide Trading Permit Holders with additional guidance and clarification on their obligations under these Rules and thus potentially increase compliance with those obligations. The proposed rule change will impose the same requirements on all Trading Permit Holders. Finally, the Exchange believes that the proposed rule change will maintain the necessary protection and priority of customer orders designed to prevent fraudulent and manipulative acts, without imposing any undue regulatory costs on industry participants.

**B. Self-Regulatory Organization's Statement on Burden on Competition**

CBOE does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The Exchange believes the proposed rule change will reduce the burdens on market participants that result from their having to comply with varying rules related to customer order protection, thus reducing the complexity of customer order protection rules, particularly for those firms subject to

the rules of multiple trading venues. Overall, the Exchange believes the proposed rule change enhances customer order protection by harmonizing customer order protection, best execution and interpositioning rules across self-regulatory organizations, which ultimately benefits market participants and does not impose a burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

The Exchange neither solicited nor received comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period up to 90 days (i) as the Commission may designate if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will:

- A. by order approve or disapprove such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2013-027 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2013-027. This file number should be included on the subject line if e-mail is used.

To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions

should refer to File Number SR-CBOE-2013-027, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>28</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>28</sup> 17 CFR 200.30-3(a)(12).